Hastings Communications and Entertainment Law Journal

Volume 16 | Number 2 Article 2

1-1-1993

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by
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Introduction

For decades American courts have pronounced that monopolies cannot have goodwill or that a monopoly's goodwill is of no value. The basis of this belief is that the monopolist's customers have no choice but to patronize the monopoly firm. This proposition does not withstand theoretical scrutiny. The value of goodwill to a firm is directly related to the elasticity[1] of demand for that firm's goods or services. Monopoly power alone, however, is insufficient to measure the elasticity of demand for those goods or services. The value of goodwill to a monopolist is also closely correlated to the ease by which competitors may enter the market, for a monopolist's goodwill can be a barrier to entry because potential entrants may perceive the goodwill as giving the monopolist a competitive advantage over any new entrants.

In recent years this issue has evolved as one of particular interest to the cable television industry. Popularly viewed as an industry of small, regional monopolies, there is no question that cable television companies exercise at least some monopolistic power. Because so many of the assets of a cable television firm are intangible, and because in so many areas of law and regulation the size and nature of a company's assets are important, the allocation of cable television companies' assets to goodwill, if such goodwill can exist, has significant consequences.

I
The History of the Doctrine

The U.S. Supreme Court articulated the principle that a monopoly cannot have goodwill or cannot assign value to goodwill as early as 1901 in *Wilcox v. Consolidated Gas Co.*[2] At issue was the valuation of the assets of the gas supplier for the city of New York. The Supreme Court stated:

> We are also of [the] opinion that it is not a case for a valuation of "good will." . . . The complainant has a monopoly in fact, and a consumer must take gas from it or go without. He will resort to the "old stand," because he cannot get gas anywhere else.[3]

The very next year, in *Omaha v. Omaha Water Co.*,[4] the U.S. Supreme Court revisited the issue. The city of Omaha had the right to purchase its privately-owned water supplier; however, the private

1. Elasticity of demand is the responsiveness of consumers to changes in prices.
2. 212 U.S. 19 (1909).
3. *Id.* at 52.
4. 218 U.S. 180 (1910).

owners and the city litigated the price, which was dependent upon the appraised value of the assets of the water supply system. With regard to the value of goodwill in the water company, the Court noted that, "[G]ood will . . . is of little or no commercial value when the business is, as here, a natural monopoly with which the customer must deal, whether he will or no[t]."[5]

Since those early cases, the proposition that a monopolist cannot value goodwill or cannot have goodwill has become almost an article of faith, with significant consequences for income taxation, property taxation and rate regulation for regulated industries, including cable television.

II
The Income Tax Issue

The Internal Revenue Code, applicable tax rules and case law allow taxpayers to amortize intangible assets that have determinable useful lives.[6] Intangible assets without determinable useful lives, such as goodwill, could not, until recently, be amortized.[7] From this prohibition has arisen one of the oldest controversies between the Internal Revenue Service and taxpayers: How much of the intangible assets of a firm are attributable to goodwill?[8]

The issue arose recently in *Tele-Communications Inc. and Subsidiaries v. Commissioner*.[9] Tele-Communications, Inc. had purchased three cable television franchises in Florida and Missouri and claimed amortization deductions based on the difference between the purchase price of the franchise and the value of the tangible assets of each system. The IRS disallowed most of the deductions.

The IRS argued that much of the purchase price was consideration for goodwill which, as a nondepreciable capital asset, could not be included in the cost-basis amortization. Tele-Communications, Inc. responded that "although there may be an element of going concern value, each franchise benefited by operating in a de facto monopoly which, by its nature, does not allow for the existence of 'goodwill.'"[10]

5. *Id.* at 202.

6. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

7. *Id.*

8. GENERAL ACCOUNTING OFFICE, GAO/GGD-91-88, TAX POLICY: ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS 2 (1991).

9. 95 T.C. 495 (1990).

10. *Id.* at 519.

The court accepted the reasoning of Tele-Communications, Inc. in ruling that it had no goodwill because it was a monopoly. The court stated, "On the basis of the facts presented, the concept of goodwill has no application. Potential cable television subscribers have no alternative but to go to the possessor of the right to deliver cable television services and, therefore, goodwill does not exist in the traditional sense."[11]

The Omnibus Budget Reconciliation Act of 1993 expressly permits, for the first time, the amortization of goodwill and other intangible assets without determinable useful lives.[12] The amortization period is fixed at fifteen years.[13] The existence and value of goodwill will remain an issue, however, because different categories of assets have different amortization schedules. For example, if goodwill may be amortized more quickly than tangible personal property, a taxpayer would argue for greater allocation of the price of the business to goodwill.

III
The Property Tax Issue

Nationwide, counties and other local governments starved for revenue by tax revolts are seeking new sources of revenue. Tax assessors in many states have taken another look at property subject to *ad valorem* taxation. In several instances, new theories have been advanced which result in substantial increases in the valuation of the property and an accompanying increase in the tax upon that property. The allocation of the value of an enterprise between taxable property and other assets, therefore, becomes a major issue. Goodwill is one of those other assets. The greater the value of an enterprise that may be attributed to goodwill, the lesser the value of the firm that may be taxable.

An example of the development of local laws raising the amount of revenue generated from property taxes is the major battle currently being fought in California between county assessors and cable television companies over the value of possessory interests. Possessory interests are the rights to use otherwise tax-exempt public property for private purposes,[14] such as leases of park land for residences or concessions. Cable television operators use public streets and other

11. *Id.* at 521.

12. Ominbus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 1993 U.S.C.C.A.N. (107 Stat.) 312, 532 (to be codified at 26 U.S.C. § 197).

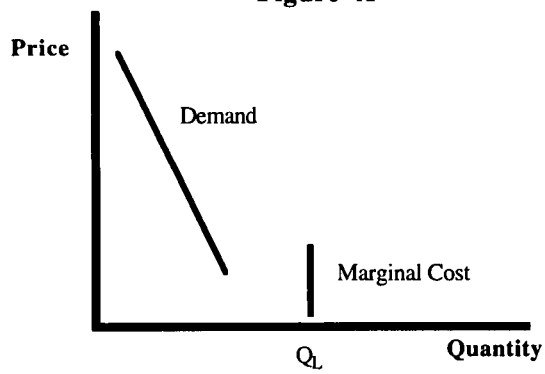
13. *Id.* (to be codified at 26 U.S.C. § 197(a)).

14. CAL. REV. & TAX. CODE §§ 107-107.7 (West 1987 & Supp. 1994).

rights-of-way for their cable plants, and it is the value of the possessory interests in these public rights-of-way that is at the heart of the controversy.

Possessory interests in public rights-of-way of the type used by cable television companies are difficult to appraise directly. There is no market price for such rights-of-way because the supply exceeds the demand and the price is regulated by law. Utility poles and streets have the capacity to provide space to more users than those seeking to use such rights-of-way. The cable television company, telephone company and power company do not use up all of the space on the poles and under the streets.

Figure A



As illustrated by Figure A above, there is no marginal cost to the owner of the rights-of-way for additional users up to the limit of the capacity of the telephone poles and streets to accommodate wires and pipelines (Q_L). Above that limit, however, supply of space in the rights-of-way is unavailable at any price. On the demand side, however, the number of potential users is exhausted before the supply. Thus, the supply and demand "curves" never intersect, so there is no determinable equilibrium price.

The owner of the rights-of-way, the local municipality, is a monopolist, so it could artificially restrict the supply. Theoretically, the municipality could exact from each utility and cable television company a price equal to the value of the use of the rights-of-way. As a practical matter, however, the municipality is incapable of determining what that value is (which is, after all, the point of this exercise), so the outcome could be any price between zero and the value of the possessory interest to the buyer. The outcome of this game, that is, what is the price for the use of the rights-of-way, is unclear. It would depend upon factors external to the value of the property, such as the political influence of the buyers or of the consumers who ultimately

pay the buyers' costs, the need of the municipalities for revenue and the relative nerve of the negotiators.

This game is not played in fact, because the prices municipalities may charge for public rights-of-way are regulated. In California, the telephone companies cannot be charged by municipalities for use of the public rights-of-way.[15] Electric and gas utilities may be charged a "franchise fee" of no more than two percent of the utility's gross revenues from that municipality.[16] Cable television operators may be charged a "franchise fee" of no more than five percent of their gross revenues.[17] The "franchise fee" pays for both the right to do business and the actual access to the public rights-of-way,[18] so not all of the franchise fee can be said to be paid for such access.

Thus, it is difficult to determine how much is actually paid for the use of the public rights-of-way, much less what the price would be if the market was unregulated. Methods other than reference to the market price, therefore, must be used to estimate the value of such possessory interests.

One of the methods being used to value possessory interests is the unitary method, which consists of appraising the value of the entire cable television enterprise, then subtracting the value of all but possessory interests. The cable system's intangible assets, including goodwill, are among those assets that are not possessory interests, and, therefore, their value must be subtracted from the enterprise value to determine the value of the possessory interests. Thus, in unitary-method appraisals of possessory interests, the greater the value of goodwill, the lower the resulting appraisal of the possessory interests.

An alternative method of appraising possessory interests is to estimate the amount of the cable operator's income that should be attributed to the possessory interests, and then determine the present value of that stream of income over the life of the franchise. This exercise in metaphysics has not been made any easier by California state court decisions. Decisions on this issue have stated that, despite California law prohibiting *ad valorem* taxation of intangible assets, the value of intangible assets may be taken into account in the appraisal of tangible assets to the extent the intangible assets enhance the value of the tangible assets.[19] Goodwill is not among the intangible assets

15. Section 7901 of California's Public Utilities Code grants telephone utilities a statewide franchise, foreclosing local franchising and regulation.

16. CAL. PUB. UTIL. CODE § 6231 (West 1987).

17. 47 U.S.C. § 542(b) (1993).

18. County of Stanislaus v. County of Stanislaus Assessment Appeals Bd., 213 Cal. App. 3d 1445, 1455 (1989); Roehm v. County of Orange, 32 Cal. 2d 280, 285 (1948).

19. *County of Stanislaus*, 213 Cal.App.3d at 1445.

that allegedly enhance the value of the possessory interests, so any income attributable to the goodwill of the cable operator cannot be imputed to the possessory interests.

California's county assessors use an elaborate appraisal of the possessory interests of Viacom's California cable systems in their task of appraising possessory interests held by cable television concerns. Appraisal of Viacom's possessory interests was a collaborative effort of assessors from ten California counties. In its discussion of goodwill, the Viacom appraisal quotes a 1982 appraisal of Wisconsin Cablecom-General cable television systems which states:

> Customer loyalty and customer referrals are valuable elements of goodwill when a newly acquired business operates in a competitive environment. Since cable television franchisees enjoy apparent exclusivity, subscribers have no choice except to patronize the sole authorized system in their area. There is no indication that customer loyalty has been established where no competition to test the loyalty of customers exists. Therefore, no goodwill of this type can be assumed to exist.[20]

"From this discussion," conclude the ten California County Assessors, "it would appear that in a defacto [sic] monopoly situation such as Viacom enjoys, goodwill either does not exist, or if its existence is conceded, its market value is $0."[21]

The issue of how to appraise possessory interests is not unique to California. The assessor of Lincoln Parish, Louisiana argues that unitary methods of appraisal are appropriate for use in property tax assessments of cable television systems because any and all of their intangible assets enhance the value of their tangible assets. With regard to goodwill, she writes:

> My question to cable TV representatives is: "Where is the 'goodwill' in a monopoly?" The answer to both this question and the valuation of so-called "goodwill" in cable TV systems is one and the same—there is "no goodwill" in monopoly cable systems, and there should be no assessment for same.[22]

20. Richard Benson et al., Appraisal of the Property of Viacom Cable, Inc., located in the Counties of: Alameda, Butte, Contra Costa, Colusa, Marin, Napa, San Francisco, Shasta, Sonoma and Tehema as of March 9, 1987, at 183 [hereinafter Appraisal of Viacom] (quoting Bond, Appraisal of Assets Cablecom-General Cable Television Systems and Corporate Divisions as of April and May, 1982, at 184-85).

21. *Id.*

22. Jewette Farley, *A Question of Fairness—The Cable TV Issue*, ASSESSMENT J., Mar.-Apr. 1994, at 2, 14-15 (originally presented as a paper at the 1993 International Association of Assessing Officers conference in Washington, D.C.) (1993).

IV
The Rate Regulation Issue

Most of the established case law on the subject of the existence of goodwill in monopolies has arisen in the context of determining whether the rates regulators have permitted utilities to charge are confiscatory. The issue in these cases has been whether the rates have been set so low as to constitute a taking of the regulated company's property by the government.[23] Among the considerations in setting rates is the size of the company's assets, so that the rate of return earned by investors on those assets may be determined. The existence and value of goodwill may have a substantial impact upon the measurement of the assets of the utility and on the revenues necessary to generate a given rate of return and, thus, on the rates the utility may charge.

Whether the existence of goodwill favors the regulators or the regulated industry is not consistent. If the regulations are based on guaranteeing a fair return on all assets, then the greater the goodwill of a company in the regulated industry, the higher the rates it may charge. On the other hand, rate regulations often exclude from consideration certain categories of assets, such as goodwill. In such cases, the company will argue that little of its value should be allocated to goodwill.

Teleprompter Cable Communications Corporation found itself in the latter situation when it appealed the rejection of a rate increase application by the New Jersey Board of Public Utility Commissioners.[24] On appeal, Teleprompter argued that the regulators had not properly distinguished between goodwill and the firm's going concern value.[25] Going concern value was includable in the "rate base," whereas goodwill was not. The court rejected Teleprompter's argument because it had not been raised before,[26] but did note in a brief survey of the law that goodwill "is not properly includable in the rate base of a monopoly."[27]

23. Calfarm Ins. Co. v. Deukmejian, 48 Cal. 3d 805, 821 (1989).

24. Teleprompter Cable Communications Corp. v. Board of Pub. Util. Comm'rs, 380 A.2d 1140 (N.J. Super. Ct. App. Div. 1977).

25. *Id.* at 1144.

26. *Id.* at 1145.

27. *Id.* The authority cited by the court is Wilcox v. Consolidated Gas Co. of New York, 212 U.S. 19 (1909), which did not hold, as a matter of law, that goodwill should be excluded from the rate base of a monopoly. Rather, *Wilcox* held that, as a matter of universal fact, a monopoly cannot have goodwill, so there is none to include in its rate base. *See supra* note 2 and accompanying text.

More recently, the Federal Communications Commission, as part of its charge under the Cable Television Consumer Protection and Competition Act of 1992, is developing rules by which cable television companies may be able to seek exceptions to the price "benchmarks" established by the FCC by showing that the benchmark rates are unreasonable given the actual costs of service. Although the benchmarks are in place, the FCC has not yet established the cost-of-service rules. The FCC has, however, tentatively decided that goodwill may not be included in the rate base to be used for cost-of-service showings.[28]

V
The Definition of Goodwill

Federal tax law cases have defined goodwill as follows:

> In tax law, it is well established that the "nature of goodwill is the expectancy that 'old customers will resort to the old place.'" The essence of goodwill is the expectancy of continued patronage, for whatever reason.[29]

The Wisconsin appraisal of Cablecom-General quoted in the California appraisal of Viacom defines goodwill as "goodwill established through competition."[30]

The dictionary defines goodwill as "benevolent interest or concern; a kindly feeling of approval."[31]

None of the above definitions is very rigorous and, therefore, none lends itself to fruitful analysis. However, examination of how the concept of goodwill is used reveals its elements.

Goodwill is a demand-side phenomenon. That is, the effect of goodwill is to increase demand for a firm's goods or services, which enables the firm benefiting from the goodwill to sell more, increase its price, or both. Demand may also be increased by any number of factors which would not qualify as goodwill, such as product differentiation. Goodwill, therefore, is a category of factors that increase demand yet escapes precise definition and measurement. Those fac-

28. Cable Television Act of 1992, 58 Fed. Reg. 40762, (1993) (to be codified at 47 C.F.R. pt. 76) (proposed July 15, 1993). In fact, the FCC has tentatively decided that no acquisition costs in excess of the original cost of the cable operator's tangible assets may be included in the ratebase.

29. Tele-Communications, Inc. and Subsidiaries v. Comm'r, 95 T.C. 495, 521 (1990) (citations omitted).

30. Benson, *supra* note 20, at 182 (quoting Bond, Appraisal of Assets Cablecom-General Cable Television Systems and Corporate Divisions as of April and May 1982, at 184-85).

31. WEBSTER'S NEW COLLEGIATE UNABRIDGED DICTIONARY 496 (1991).

tors would include benevolent feelings on the part of consumers, force of habit from a firm's long tenure in the community and the firm's reputation.

Goodwill as a business asset is sometimes defined in terms of competition—as the tendency of a business, because of its reputation, to attract customers who might otherwise go to a competitor. This might also be described as a friendlier disposition on the part of the customers to a particular business over its competitors.

Goodwill may also be defined without mention of competition, however, as the tendency of a business, because of its reputation, to attract customers who might not otherwise patronize that business. That is, a business may be the beneficiary of a friendly disposition on the part of its customers regardless of the existence of competition.

When goodwill is defined as requiring an element of competition, there is a question of whether a monopolist can have goodwill. However, conceptually, a monopoly could benefit from a friendly disposition on the part of potential customers regardless of the existence of competitors. That is, there are customers whose choice is between purchasing the monopolist's product and not purchasing that product at all. The decision of those potential customers whether to purchase a certain good or service may, at the margin, depend upon the reputation of the seller.

VI
The Value of Goodwill to a Monopolist

The ability of any firm, including a monopolist, to attract customers because of its reputation, service and the fact that its potential patrons feel good about patronizing it, would be a valuable asset unless the firm is operating in a market in which demand for its goods or services is unrelated to price and service. Only the firm that can sell its products at any price will assign no value to goodwill's ability to attract customers. That is, the value of goodwill is correlated with the elasticity of demand for the firm's goods or services, and the existence of monopoly power reduces the value of goodwill only to the same extent that monopoly power necessarily implies lower elasticity of demand.

Figure B

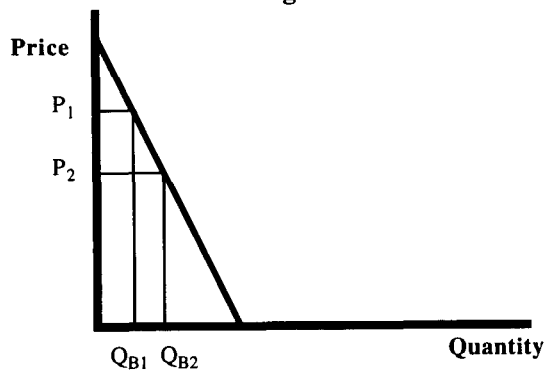
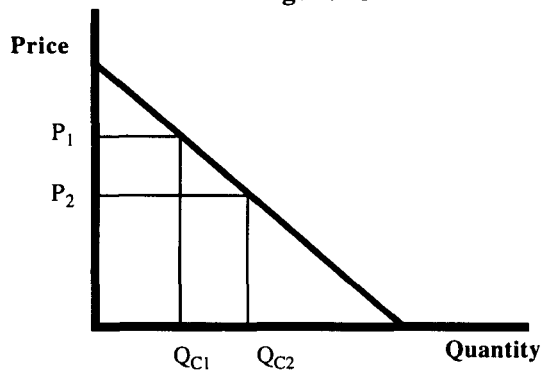


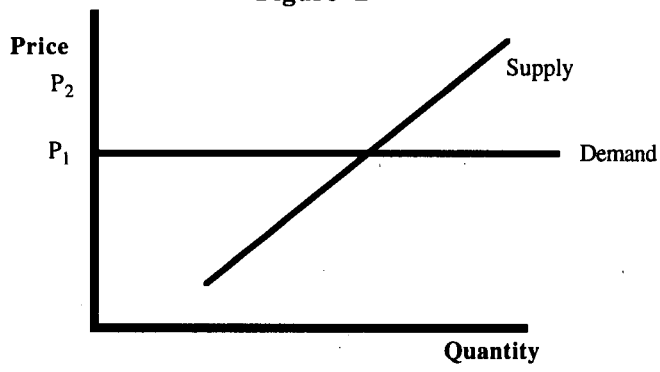
Figure C



Figures B and C each show the market demand for a product. Demand for the product in Figure C is more elastic than is demand for the product in Figure B; demand is more sensitive to changes in price. The same price change, from P_1 to P_2, results in a larger change in consumption in market C than in market B (*i.e.*, Q_{C2}-Q_{C1}>Q_{B2}-Q_{B1}.)

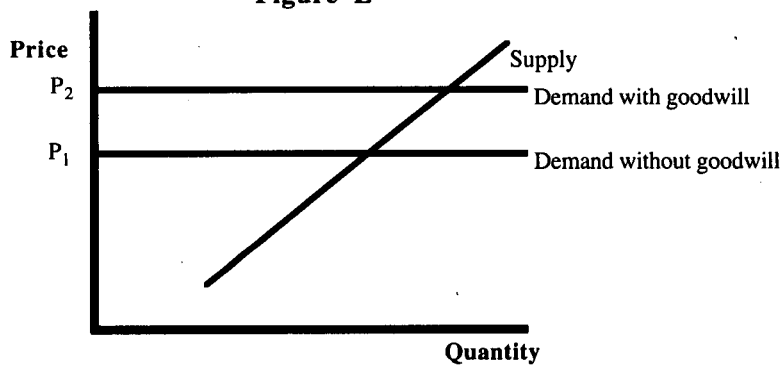
In a competitive market, an individual firm has virtually no ability to set prices. Each individual firm is relatively insignificant, so any increase above the price being charged by competitors (*e.g.*, P_1 to P_2) will drive all of the firm's customers to those competitors.

Figure D



To the individual firm in a competitive market, therefore, demand is infinitely elastic. The presence of goodwill, however, permits the firm to differentiate itself from its competitors and charge a higher price.

Figure E



The increase in the firm's profits is represented by the area between P_1 and P_2 and to the left of the supply curve.

The ability of a competitive firm, through an investment in goodwill, to increase demand for its products or services can be understood intuitively by thinking of the price of those products or services as consisting of all demand factors, not just the amount of money with which one must part to acquire the good or service. That is, money is only part of the price paid by consumers for purchases. Consumers also pay with their time spent shopping and with the difficulty of obtaining and evaluating product information. For example, some consumers still purchase goods at full retail price, despite the proliferation of discounters such as Wal-Mart, Target and Costco, because they value the service and atmosphere provided by full-service retailers more than the dollar price difference between the full-service retailer and the discounter.

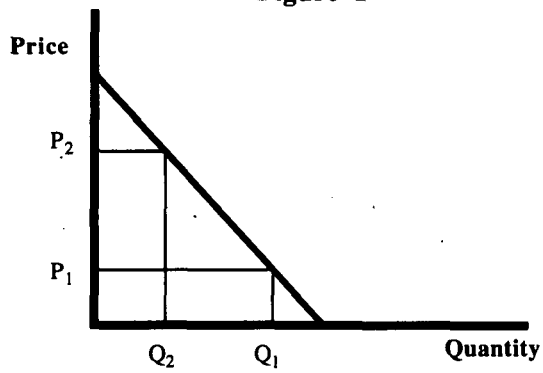
Thus, the overall price of a good can be reduced if, the dollar price being equal, the level of service offered to the customer increases. Consumers' impressions that a seller offers superior service is goodwill. The presence of goodwill, therefore, is the belief by consumers that the overall price for a good is lower at the business which is the beneficiary of the goodwill.

Whether a consumer purchases a good or service or how much of a good or service to buy is decided by weighing the marginal benefit or attractiveness of that purchase against alternative uses for the resources used to make the purchase—the overall price as defined above. Consumers who perceive the marginal benefit of a purchase to be high will make the purchase, and would, in fact, make the purchase even if the price were higher. At any price level, however, there are purchasers and potential purchasers for whom the decision is very close, for whom the marginal benefit of the purchase is very small compared with the price. It is those consumers whose decision to purchase may be influenced by how good they feel about the company from which they are considering making the purchase.

All of the discussion set forth above applies equally well to monopolists as to companies in a competitive market. The difference between a monopolist and a company in a competitive market is that the monopolist is the only producer or supplier in the market. This has two primary implications.

First, a price increase by the monopolist, unlike a price increase by a company in the competitive market, does not result in wholesale desertion of its customers to competitors. As long as demand is elastic at all, however, a price increase (from, for example, P_1 to P_2) would result in a decrease in purchases (from Q_1 to Q_2).

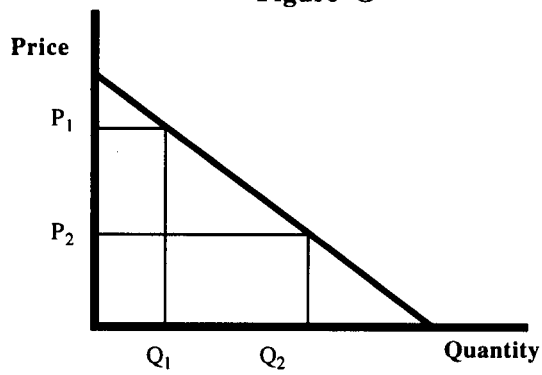
Figure F



Second, unlike the company in the competitive market, the price charged by the monopolist is greater than its marginal revenue, the

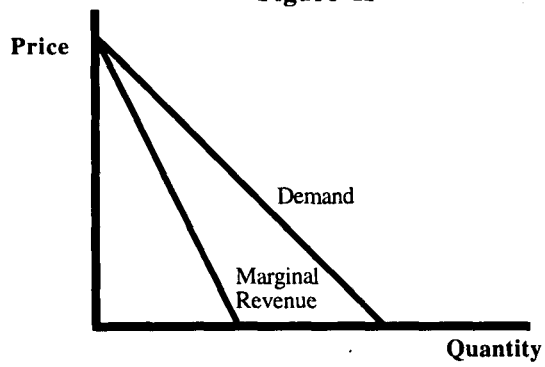
additional revenue to be gained from each additional sale. The market price represents marginal revenue for a competitive company which produces an insignificant portion of the entire market supply, and, therefore, cannot individually affect the market price for its goods or services. The monopolist, on the other hand, is the only producer, so if it increases production, it must reduce the price it charges (which is the same as the market price) in order to sell the additional units produced. The monopolist has to reduce the price of all of its units, not just those representing the increased production, so the marginal revenue from each additional sale by the monopolist is lower than the price because the supply increase depresses the price for all of the monopolist's goods.

Figure G



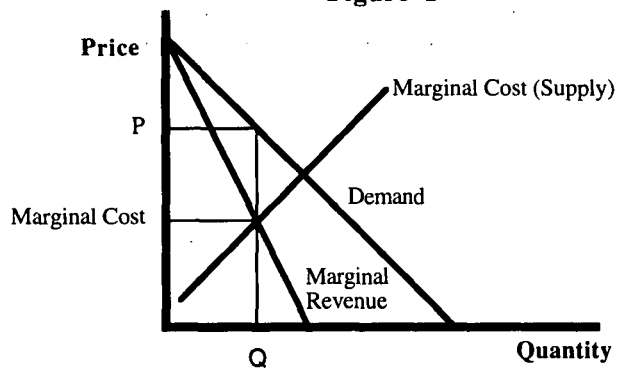
As illustrated in Figure G, for example, the increase in production from Q_1 to Q_2 forces the price charged to drop from P_1 to P_2. That new lower price, however, is charged for all items sold, including the Q_1 items formerly sold at the higher price. Thus, the monopolist gains $(Q_2\text{-}Q_1)P_2$, but loses $Q_1(P_1\text{-}P_2)$. In fact, if the monopolist's demand curve is linear and downward-sloping, the marginal revenue curve bisects the demand curve.

Figure H



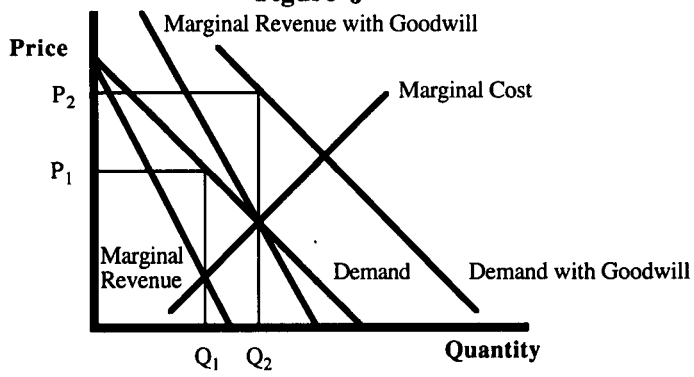
Profits are maximized, both for the monopolist and for the companies in a competitive market, when the marginal revenues are equal to the marginal costs of production (*i.e.*, when there is no more profit to be made from additional sales). In the competitive market, the marginal revenue is the price, so the price charged is equal to the marginal cost. A monopolist's marginal revenues, however, are lower than the price, so the price is higher than the marginal cost of production at its profit-maximizing point. That difference between the cost of production and the price is the "surplus," or monopoly profit, which gives rise to much of the opprobrium associated with monopolies.

Figure I



If a monopolist invests in goodwill, then its demand function moves vertically by the amount of the monetary value to its customers of the improved service or reputation. The monopolist, thus, is able to increase its price and increase production.

Figure J



The increase in profit to the monopolist from its investment in goodwill is P_2Q_2 minus P_1Q_1 minus the area between Q_1 and Q_2 below the supply curve.

Therefore, goodwill, defined as the ability to charge a higher monetary price without losing customers (because those customers perceive that the firm offers savings in terms of service and quality), should be of benefit and value to a monopolist.

Judge Goffe in the *Tele-Communications, Inc.* case recognized that a monopolist can benefit from and, therefore, value goodwill:

> At the time petitioner acquired the Jefferson City and Titusville cable systems, there were a large number of subscriber complaints because Athena's poor financial condition prevented it from making the investment necessary to provide a satisfactory level of service in those communities. Customer satisfaction, or lack of it, was not a factor petitioner considered when valuing a cable system before purchasing it. In fact, the poor reputation of an existing franchisee often works to the buyer's advantage because the buyer then has the opportunity to improve the system.[32]

The opportunity to improve the system's reputation for service could work to the buyer's advantage only if such improvements would increase the number of subscribers and/or the price that could be charged to subscribers. Therefore, Judge Goffe recognized that goodwill exists even in what he considers a monopoly.

A monopolist should be more interested in goodwill than a competitive firm. One of the essential attributes of a competitive market is equality of opportunity among the firms in the market. That is, anything one firm can do another can also do, and entry into and exit from the market are easy. Thus, a firm in a competitive market that gains an advantage by an investment in goodwill should find that the advantage is only momentary. Moreover, since the other firms in the

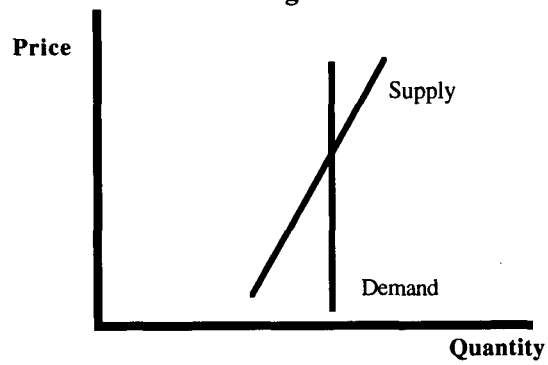
32. Tele-Communications, Inc. and Subsidiaries v. Comm'r, 95 T.C. 495, 502 (1990).

market will react by investing in goodwill themselves, potential new entrants, seeing one firm beginning to make extra profits, will be induced to enter the market.

The monopolist, on the other hand, is a monopolist because there is some barrier to entry by other firms. The monopolist, therefore, should be able to enjoy the extra profits generated by its investment in goodwill for as long as the barriers to entry persist.

Goodwill exists as long as demand is at all elastic. Only the monopolist with inelastic demand—demand insensitive to price—will assign no value to goodwill. If consumers' behavior is independent of the price for the goods or services, the monopolist already has the ability to sell at any price it chooses, so a friendly disposition on the part of its customers is of no value.

Figure K



As illustrated in Figure K, vertical movement of the demand curve due to the presence of goodwill has no impact, in contrast to the case when demand is at all elastic.[33] That is, when demand is perfectly inelastic, nothing the seller can do, short of ceasing production altogether, will influence the quantity to be purchased. The seller has no incentive, therefore, to care what purchasers think. Goods or services with perfectly inelastic demand are rare or non-existent, but short-term residential demand for public utilities such as electricity, natural gas and water, is a good example which comes close. In the short run, for instance, increases in price for natural gas will not affect residential consumption, because the need for heat and to cook remains constant, and adjustment to less expensive alternatives takes time and is, itself, costly.

The cases that established the rule followed in the *Tele-Communications, Inc.* case were ones involving the regulation of public utili-

33. *See* Figure J *supra.*

ties. Although those cases concluded there could not be goodwill in a monopoly, the analyses used by the courts imply that the monopolists in question in those cases were facing inelastic demand.

For example, in *Wilcox v. Consolidated Gas Co.*,[34] the Supreme Court at least implicitly recognized that the absence of consumer choice (inelasticity of demand) rendered goodwill of no value to the supplier of natural gas for the city of New York:

> We are also of [the] opinion that it is not a case for a valuation of "good will." . . . The complainant has a monopoly in fact, and a consumer must take gas from it or go without. He will resort to the "old stand," because he cannot get gas anywhere else.[35]

Similarly, in *Omaha v. Omaha Water Co.*,[36] the Supreme Court noted that the municipal water supplier had inelastic demand because, "the business is, as here, a natural monopoly *with which the customer must deal, whether he will or no[t].*"[37] The Supreme Court, thus, in both cases found *both* that the utility was a monopoly *and* that customers had no choice but to patronize it—that demand was inelastic. Later cases have used the concepts less carefully but, with the exception of the *Tele-Communications, Inc.* case, have usually arrived at the correct result nonetheless.

In *Montgomery Coca-Cola Bottling Co. v. United States*,[38] the plaintiff corporation owned Coca-Cola bottling franchises and leased them to partnerships owned by plaintiff's shareholders. The controversy was how much of the premium paid to the plaintiff corporation by the partnerships over the cost of the syrup purchased from Coca-Cola was royalties for the franchise. The plaintiff argued that the government had undervalued the leaseholds by not assigning value to goodwill. The court ruled that the bottling franchises had no goodwill, because any goodwill attached solely to the product and was, therefore, an asset of the Coca-Cola company, not of its bottlers. The court also noted that each bottler had an exclusive territory and was, therefore, a monopolist, and, "since the potential customers have no alternative to go to the possessor of the right, there may be no goodwill in the traditional sense."[39]

The court's decision as stated is rife with confusion over whether the appropriate market for analysis is the retail market or the wholesale market. The court is probably correct in stating that any goodwill

34. 212 U.S. 19 (1909).
35. *Id.* at 52.
36. 218 U.S. 180 (1910).
37. *Id.* at 202 (emphasis added).
38. 615 F.2d 1318 (Ct. Cl. 1980).
39. *Id.* at 1332.

on the part of retail consumers of Coca-Cola products is an asset of Coca-Cola, independent of who bottles and distributes the product. The bottlers' customers, however, are retail sellers, not consumers, so it is conceivable that the goodwill of those retailers was an asset of the bottlers. Nonetheless, given the large amount of consumer goodwill owned by Coca-Cola, demand for Coca-Cola by retailers within a price range not too far above the prices charged by competitors is probably inelastic. That is, unless the wholesale price of Coca-Cola is significantly greater than that of Pepsi-Cola, a retailer is virtually required to carry Coca-Cola. Thus, it is quite possible that the court was correct in stating that the goodwill of retailers had no value to the bottler because it was a monopolist and because demand for its products was inelastic.

Thus, there is no logical reason why a monopolist could not have goodwill. The very fact that a monopolist, or any firm, faces price-sensitive demand for its products implies the potential existence and value of goodwill. The value of goodwill, however, is correlated with the degree of elasticity of demand.

VII
Monopoly Power and Elasticity of Demand

A monopoly is a firm that is alone in its market. Unfortunately, defining the relevant market in order to determine whether a firm is alone in it is not simple. Cable television operators, for example, are almost always the sole providers of cable television services in their franchise areas, but they face substantial competition for consumers' dollars from purveyors of alternative forms of entertainment, such as broadcast television,[40] video rentals[41] and movies. On the horizon are other methods of delivering multichannel video entertainment to households, such as Direct Broadcast Satellites (DBS) and Multichannel Multipoint Distribution Systems (MMDS or "wireless cable") which will increase the level of competition with cable television.

Thinking in terms of degrees of monopoly power, then, is more useful than thinking in absolutes. Currently, cable television operators have monopoly power because competitive products are not close substitutes. Broadcast television offers significantly fewer channels.

40. A strong negative correlation has been observed between the number of broadcast television signals available (up to five) and the rate of penetration of cable television subscriptions. James Dertouzos and Steven Wildman, Problems with Penetration Standards, a report to the National Cable Television Association 6 (Feb. 12, 1991 draft).

41. A strong negative correlation has been observed between the percentage of homes owning video cassette recorders and penetration of cable television subscriptions. *Id.*

Video rentals are more expensive per viewing and require that a customer leave home to rent and to return the tape.

The greater the monopoly power, the lesser the elasticity of demand. For example, while increases in the price of cable television subscriptions would cause some customers to defect to alternative forms of entertainment, other customers would remain, thinking that the alternatives are still more expensive in terms of money, inconvenience and time, and that the other products are still not sufficiently good substitutes to offset the higher price of cable television. However, upon the advent of DBS and MMDS, subscribers to cable television will be much more readily driven away from cable television by price increases because of the availability of closer substitutes. Thus, greater competition means greater elasticity of demand.

The correlation between monopoly power and elasticity of demand is not absolute, however, because consumers often have available to them the choice of not consuming the monopolist's product at all. Even if cable television were truly a monopoly, with no competition whatsoever, it would not face inelastic demand and would value goodwill, because cable television programming is not a necessity. At some price, potential subscribers will decline to subscribe regardless of the availability of alternatives. This is in contrast to the customers of the gas company in *Wilcox v. Consolidated Gas Co.* and the customers of the water company in *Omaha v. Omaha Water Co.*, who must patronize those firms in order to obtain such necessities as heat and fresh water. At the margin, the goodwill, or lack thereof, of the cable television operator will make the difference in the decisions of some potential cable television subscribers.

VIII
The Value of Goodwill as a Deterrent to Entry

Goodwill also has value to a monopolist as a deterrent to entry by potential competitors. For example, an MMDS or DBS operator is much more likely to enter a cable television operator's market if the cable television operator has a poor reputation for service. There, the prospects for stealing the cable system's subscribers would be much better than if the cable system had a good relationship with its public. A smart cable television operator, therefore, will value goodwill now even though competition from MMDS and DBS does not yet exist.

The concept that the value of goodwill is correlated with the likelihood of entry into a market where incumbents have monopoly power is not different from the correlation between elasticity of de-

mand and the value of goodwill. The likelihood of entry is nothing more than long-term elasticity.

IX
The Experience of the Cable Television Industry

Empirically, the experience of the cable television industry has proven to cable television operators the value of goodwill among the residents of its franchise area. In recent years, the National Cable Television Association created customer service standards for its members, which include answering the telephone within thirty seconds, keeping service appointments and resolving billing questions quickly.[42] Although one motive for creating such standards appears undoubtedly political—improving the industry's popularity to defuse political backlash from a poor reputation for customer service—the motive for adoption of the standards by individual cable operators was to increase goodwill and, thereby, increase revenues.

The evidence for the latter is largely anecdotal, but it is compelling. For example, in Long Beach, California, Simmons Communication purchased a cable system with a terrible reputation for customer service. Simmons imposed customer service standards, improved service by reducing outages and became actively engaged in the community through fundraisers for local charities. As a result, "churn" (turnover of subscribers) was reduced by thirty percent, as was the system's bad-debt ratio.[43] Thus, improved service and image meant that customers who would formerly have cancelled their subscriptions did not and customers who formerly would have refused to pay their bills paid.

Further evidence of the interest of cable television operators in creating goodwill may be found in the advertisements that grace the pages of cable television industry publications, such as Multichannel News. Companies, such as Electronic Data Systems Corporation (EDS), place advertisements aimed at cable operators which describe ways the operators can serve their customers better.[44] The inference is that cable operators will invest in services and products if those services and products will create goodwill among customers.

42. NATIONAL CABLE TELEVISION ASS'N, RECOMMENDED CABLE INDUSTRY CUSTOMER SERVICE STANDARDS (1990).

43. John M. Higgins & Linda Haugstead, *Shrinking Simmons Wants to Grow Again*, MULTICHANNEL NEWS, Oct. 5, 1992, at 44.

44. *E.g.*, EDS advertisement, MULTICHANNEL NEWS, Mar 22, 1993, at 26-27 (Ads say such things as, "So your customers receive immediate attention" and "systems that best help you satisfy your customers' needs").

X
Conclusion

The value of goodwill to any business, including a cable television operator, is primarily a function of the elasticity of demand for that business' products. Because monopoly power is correlated with inelasticity of demand, the more monopoly power exercised by a business, the lower the value of goodwill to that business. Monopoly power, however, is not the only determinant of elasticity of demand, so even a monopolist may face elastic demand, and, thus, assign value to goodwill. To the extent that monopoly power does not necessarily imply inelastic demand, the presence of monopoly power enables a firm to retain more of the benefits of the presence of goodwill than could a competitive firm, thus making goodwill possibly even more valuable to a monopolist than to a competitive firm in a similar market. Finally, to the extent that firms look to the future, even a monopolist facing perfectly inelastic demand might value goodwill as a deterrent to entry by potential competitors.